Supreme Court, U.S.
FILED
SEP 26 1980
MICHAEL RODAK, JR., CLERK

No. 80-272

# In the Supreme Court of the United States

OCTOBER TERM, 1979

T. F. H. PUBLICATIONS, INC., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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In this federal income tax case, petitioner, an accrual basis taxpayer, seeks review of the decision below holding that its receipt of tangible assets in exchange for its assumption of an obligation to provide future advertising services resulted in its realization of income in the taxable year of receipt, rather than in the future years in which it provided such services.

The pertinent facts may be summarized as follows: In 1971, petitioner, a New Jersey corporation, purchased the assets of a printing business. As part of the purchase price, petitioner agreed to provide to the seller discounted advertising in its publications during the next several years. The agreement required petitioner to publish an average of ten pages per month of the seller's advertising at a cost to the seller of 10 percent of the lowest rate

charged other advertisers, until $400,000 had been billed to the seller. Accordingly, the parties to the asset sale deemed the value of the advertising discount to be approximately $360,000 (Pet. App. A5, A7-A8, A13, A26).

On audit, the Commissioner of Internal Revenue determined that petitioner had received publication assets with a value of $360,000 in the 1971 transaction in exchange for its assumption of an obligation to provide advertising services in the future, and, therefore, that the receipt of the assets as prepayment for services constituted income in the amount of $360,000 to petitioner in the year of receipt (Pet. App. A26).

In this suit brought by petitioner in the Tax Court for redetermination of the deficiencies, petitioner contended, *inter alia*, that any income arising from the transaction was to be recognized only over the course of the years in which the advertising was actually to be furnished and not entirely in 1971. The Tax Court upheld the Commissioner's determination (Pet. App. A33-A34), and the court of appeals affirmed (Pet. App. A35).

1. The decision below correctly held that the entire $360,000 of income was allocable to petitioner's 1971 taxable year, the year in which petitioner received full control and use of the assets. This result was mandated by a definitive trilogy of decisions of this Court, which established the general rule that prepaid income received by a taxpayer in one year in return for services to be performed by the taxpayer in future years is includable in the taxpayer's income in the year of receipt, and may not be deferred to the future years of performance. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180 (1957); *American Automobile Assn.* v. *United States*, 367 U.S. 687 (1961); *Schlude* v. *Commissioner*, 372 U.S. 128 (1963).

Contrary to petitioner's argument (Pet. 5-7), the decision below does not conflict with *Artnell Co.* v. *Commissioner*, 400 F. 2d 981 (7th Cir. 1968), and *Beacon Publishing Co.* v. *Commissioner*, 218 F. 2d 697 (10th Cir. 1955). In *Artnell*, the court found (400 F. 2d at 984) an exception to the general non-deferral rule of *Automobile Club, American Automobile Assn.*, and *Schlude*, for situations in which "under the facts of a particular case, the extent and time of future performance [is] so certain, and related items properly accounted for with such clarity," that the deferral technique will clearly reflect income. Here, the Tax Court specifically considered *Artnell*, but concluded that because the time and extent of petitioner's future performance of the advertising services here was not at all certain, the rule of that case was inapplicable (Pet. App. A32-A33). *Beacon Publishing* is likewise distinguishable. Unlike that case, in which the taxpayer was obligated to deliver magazines over a prescribed period of time, the services involved here "are performed only upon * * * demand and the taxpayer's performance was not related to fixed dates after the tax year." *Automobile Club of Michigan* v. *Commissioner*, *supra*, 353 U.S. at 189, n.20, distinguishing *Beacon Publishing*. See also *American Automobile Assn.* v. *United States*, *supra*, 367 U.S. at 691, n.4.

2. Petitioner further contends (Pet. 7-10) that the fact that the transaction occurred at the time of the purchase of the publication business, rather than during the "ordinary course" of petitioner's business, precludes the applicability of the rule against deferral. But the courts below correctly rejected this suggested distinction. Petitioner did not realize income simply by purchasing assets, but only because it offered as partial consideration for the assets its future advertising services, which would be rendered in the ordinary course of its business. Despite

the fact that petitioner in 1971 was only beginning its operation of the publication business, it received payment in that year for services it would render at various undetermined times in the future in the course of that business. Thus, this case comes squarely under the rationale of *Schlude* and its predecessor decisions, which held that deferral of prepayments for future business services did not clearly reflect income for federal tax purposes.

3. Petitioner also argues (Pet. 10-13) that the Commissioner abused his discretion in disallowing its deferral accounting method because it more accurately reflected its income than the inclusion of the entire $360,000 in 1971. As petitioner sees the matter, recognition of the entire sum in a year prior to the years in which it incurred the corresponding expenses in providing the advertising would distort rather than clearly reflect its income.

But as the Tax Court correctly recognized (Pet. App. A29-A30), this Court's decisions in *Automobile Club, American Automobile Assn.*, and *Schlude* have already rejected such an argument. In *American Automobile Assn.*, the Court observed (367 U.S. at 692) that although deferred income accounting "doubtless presents a rather accurate image of the total financial structure" of the taxpayer, it concluded that such deferral nevertheless "fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner." In other words, this Court found that it was not unreasonable for the Commissioner to determine that the recognition of prepayments as income in the year of receipt reflects taxable income on a year-by-year basis more accurately than other accounting methods, even though other methods might more accurately reflect the financial condition of a business over a long period of time.

4. Finally, petitioner (Pet. 13) argues that the Tax Court "improperly fragmentized" the transaction by referring to petitioner's performance of the advertising services as the "second step" (Pet. App. A33-A34). But in so characterizing the performance of future advertising services, the Tax Court was not "fragmentizing" the transaction but simply emphasizing the critical fact that the services that petitioner agreed to render would be performed in the course of petitioner's publishing business in subsequent years. In pointing to this fact, the Tax Court was properly focussed on the portion of the purchase price that consisted of services and the fact that such services would be performed in the future. The reference to the performance of such services as a "second step" was therefore not error.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
*Solicitor General*

SEPTEMBER 1980

DOJ-1980-09